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OVERVIEW

-- The foreign financial bind facing the Soviets and their East European allies this decade provides an unusual opportunity to use economic means to influence Moscow's behavoir. As with most other such leverage possibilities, the impact will be subtle and undramatic, and it could take years before these modest results become apparent.

-- Successful Western efforts to sustain or tighten the financial bind will force Moscow to make difficult choices among key priorities--enhancing the military, feeding the population, improving the civilian economy, and expanding (or maintaining) its foreign empire. Such an effort thus would make Moscow think twice about new foreign involvements and could make it more amenable to realistic negotiations with the West on military matters. It, however, could not force the Soviet regime to take actions which it believes run counter to its vital national interests--e.g., withdrawal from Afghanistan or allowing Poland to slip out of its power orbit.

-- Among the various means of crimping the foreign exchange available to the Soviets, the most plausible method now seems to be the limitation of new loans to the Soviet Bloc. Two key factors lead to this conclusion:

- Credit limitations would take advantage of already strong and prevailing political-economic circumstances. The Soviet Bloc has become highly dependent on foreign loans to sustain

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economic progress and in some cases even to maintain the current level of economic activity. Western nations and especially commercial financial institutions have become less inclined to lend large sums to the Soviet Bloc as they see little hope that the East's economic and financial situation will improve much, as long as current economic policies are pursued. The likely continuation of a Polish crackdown makes selling the idea of credit limitations easier.

- Western cohesion--so necessary for effective economic leverage--stands a much better chance in the case of credit limitations than do other proposals, such as halting the development of the Yamal gas pipeline, greatly reducing Western purchases of Soviet Bloc exports, pushing down the world market prices for key Soviet exports (gold, diamonds and oil), or embargoing trade with the Soviet Union. Western Europe and Japan would certainly believe they have much less to lose from imposing credit restrictions than by employing these other economic leverage possibilities.

-- <u>Although Western nations are at present disinclined to provide the Soviets and their allies with new credits, it is important to put the credit restraints in place now.</u> After the memories of the East European defaults and of the Polish political repression subside, it will be much harder to achieve credit constraints. Action now also would send a strong signal to Moscow as to the West's cohesion and strength (a factor that would also help overcome the current belief that the Atlantic Alliance is incapable of collective

decisions). Finally, it would preserve an important bargaining chip for the future, in the sense that the possibility of expanded credits could be dangled before a pressed Soviet leadership, especially in the post-Brezhnev era.

-- The kind of restraint on credit most feasible under current conditions is a cap on the flow of new credit that would not exceed recent levels rather than a cutoff of all loans or a sharp curtailment of new credits.

- It would be near impossible to achieve a unified Western policy stance on the stricter latter two approaches.
- It is not necessary to achieve the more stringent steps to make the financial situation worse for the Soviet Bloc. Even the expected leakage of new credits through third countries or by "cheating" by the Western nations would do little to reduce the impact of credit limitations.
- It would leave open the possibility of imposing more stringent financial credit restrictions in the future.
- A sharp curtailment or cutoff would increase the chance of a default by East European countries and could impel the Soviets to more desperate action.

-- The simplest way of achieving credit limitations seems to be through restrictions on government-guaranteed credit.

- Control over government lending is centralized; it would be difficult to regulate the flow of private lending.

- Limits on government-guaranteed credits would help curtail private lending to the East Europeans by making these countries pay market rates on a greater portion of their credit needs and by shifting the risk premium to the private lenders.

-- A companion element of the credit limitations would be the elimination or reduction of the concessional element on government loans to the USSR and its allies. The competitive pressure for East European business has induced Western countries to provide loans to the Soviet Bloc at much less than market rates, forcing the taxpayer to pay the difference. Given their budgetary problems, the governments of Europe and Japan might find it a particularly good time to cut these subsidies.

-- In sum, the two key points here are:

- The limiting of new credits to the Eastern Bloc at near recent levels would significantly constrain Soviet policy choices.
- Such credit restraints are all that are politically feasible in terms of the long term interests of our allies.